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Do I really need commodities in my portfolio?

A well-diversified portfolio always includes some investments that are performing well and others that are lagging. As an advisor, you no doubt receive accolades from clients about the winners—but also get quizzed (sometimes grilled?) about the laggards.

One of those laggards you've likely had some challenging conversations about recently is commodities. In the past five years ending June 30, 2017, the Bloomberg Commodity Index has had a -9.25% return. Year-to-date as of September 14, 2017, the Bloomberg Commodity Index return stands at -2.18%, so those tough conversations may persist into the coming quarter-end cycle.

We see three reasons for not throwing in the towel on commodities. This perspective may help allay client concerns, too.

Commodities have historically offered multiple layers of diversification

If the last five-year return period is proof of anything, it certainly demonstrates that **commodities are typically diversifiers to traditional stocks and bonds**. After all, at a time when commodities posted negative returns for five years ending June 30, 2017, the S&P 500® Index returned 14.63% and bonds (Bloomberg Barclays U.S. Aggregate Bond Index) posted a 2.21% return. Of course, past performance is no guarantee of future return, but, as the chart below shows, commodities have long exhibited less correlation with equities and bonds than other real assets (such as infrastructure and real estate), helping smooth the performance pattern of diversified portfolios.

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Best	39.42	5.24	78.51	19.63	7.84	27.73	33.55	15.02	0.55	12.74
	16.23	-35.65	37.13	18.88	1.03	18.22	22.78	12.56	0.48	11.77
	11.17	-37.31	31.78	16.93	-6.46	17.32	3.67	5.97	-0.79	11.19
	6.97	-43.38	28.34	16.83	-12.14	16.42	-2.02	-2.19	-0.81	4.06
	5.14	-48.16	18.91	7.75	-13.32	4.21	-2.60	-4.90	-14.92	2.65
Worst	-7.39	-53.33	5.93	6.54	-18.42	-1.06	-9.52	-17.01	-24.66	1.00

- Russell 3000 Index
- Bloomberg Commodity Index Total Return
- FTSE EPRA/NAREIT Developed Index
- MSCI EAFE Index
- MSCI Emerging Markets Index
- Bloomberg Barclays U.S. Aggregate Bond Index

Index returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.

This diversification extends into commodities as an asset class as well. Gold and oil are the most commonly thought of commodities, but the category is much broader than that. Commodities encompass goods such as precious metals, livestock, soybeans or coffee beans - all "real assets" that are used to manufacture products used by consumers around the world. Indeed, commodities are sourced and consumed globally, historically making their performance in aggregate relatively immune from the economic or political conditions of any single country.

Why are these diversification benefits potentially beneficial to investors now? Because of the later stage of the economic cycle that we find ourselves in today—accompanied by the probability of higher interest rates, inflation, and market volatility. We believe the diversification prospects of commodities will become more apparent and appreciated in the coming years. Buying commodities low may help bolster future portfolio returns.

The long-term outlook for commodities appears promising

According to the United Nations, the world's population is estimated to grow by about 83 million people per year[1] between now and 2030. This creates an ongoing and increasing demand for energy, food, and other real assets. Demand may very well exceed supply for many commodities in the years to come, which would support commodities prices.

Commodities have the potential to help buffer against inflation

Historically, commodities have tended to outperform other asset classes, particularly equities, during periods of unexpected high inflation. That was certainly the case in the mid-1970s and periods of the 1980s when inflation reached nearly 15%.

While we don't expect inflation to rise to those levels anytime soon, an improving global economy has the potential to spur demand for commodity-related products, causing commodity prices to rise. As an investment, commodities may keep pace with the inflationary pressures that build as the economy rallies. While we have gone a long time without any meaningful inflationary pressures, an improving global economy could change that.

The bottom line

Looking forward, we expect a commodities allocation commensurate with the investor's risk tolerance to be additive to diversified portfolios. We believe investors have the potential to benefit from an asset class that has the may improve portfolio diversification, provide access to global growth, and act as a potential inflation buffer—particularly in today's market environment.

Disclosures:

[1] Source: United Nations World Population Prospects, 2017 Revision, https://esa.un.org/unpd/wpp/Publications/Files/WPP2017_KeyFindings.pdf

particularly if the investments involve leverage. The value of commodity-linked derivative instruments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates or sectors affecting a particular industry or commodity and international economic, political and regulatory developments. The use of leveraged commodity-linked derivatives creates an opportunity for increased return, but also creates the possibility for a greater loss.

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Bloomberg Commodity Index Total Return: Composed of futures contracts on physical commodities. Unlike equities, which typically entitle the holder to a continuing stake in a corporation, commodity futures contracts normally specify a certain date for the delivery of the underlying physical commodity. In order to avoid the delivery process and maintain a long futures position, nearby contracts must be sold and contracts that have not yet reached the delivery period must be purchased. This process is known as "rolling" a futures position.

Bloomberg Barclays U.S. Aggregate Bond Index: An index, with income reinvested, generally representative of intermediate-term government bonds, investment grade corporate debt securities, and mortgage-backed securities. (specifically: Barclays Government/Corporate Bond Index, the Asset-Backed Securities Index, and the Mortgage-Backed Securities Index).

FTSE EPRA/NAREIT Developed Index: A global market capitalization weighted index composed of listed real estate securities in the North American, European and Asian real estate markets.

Russell 3000® Index: An index that measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market.

MSCI EAFE (Europe, Australasia, Far East) Index: A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

MSCI Emerging Markets Index: A float-adjusted market capitalization index that consists of indices in 21 emerging economies: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

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